

**Prepared Remarks of Jim Caspary
House Agriculture Committee Hearing
New Cooperative Business Structures
October 16, 2003**

Thank you, Chairman Goodlatte and Congressman Stenholm for conducting this hearing today to examine the structure of agricultural cooperatives and issues related to their financing.

ICBA Members – Serving Agriculture & Rural Communities

I am the President of the First National Bank of Clifton, Clifton Illinois. I am also the Chairman of ICBA's Agriculture-Rural America Committee. First National Bank of Clifton is a Midwestern agricultural bank with \$30 million in assets that has been serving the community of Clifton since 1902. It is located in the north central part of Illinois where the primary agricultural commodities are corn and soybeans. The bank owns an insurance agency which sells crop insurance and is one of the largest providers of crop insurance in the state of Illinois.

75 percent of ICBA member banks are located in small communities of under 10,000 population and our members have a long-standing interest in providing credit to American agriculture and our rural communities. ICBA is the only national trade organization that exclusively represents the interests of our nation's community banks.

Importance of To day's Hearing

The hearing today affords us an opportunity to review options for enhancing the equity positions of farmer-owned cooperatives. Two states, for example, Wyoming and Minnesota, have passed state laws designed to add greater flexibility in allowing cooperatives to attract equity from outside investments, but this model law has also raised several questions from among those in agriculture that follow these issues closely. Under this model, outside investors could form LLCs labeled "farmer-owned cooperatives", even when farmers don't have majority ownership or voting control and be eligible for cooperative benefits.

We are opposed to the CoBank legislative proposal in its current form because of its far-reaching implications and because it would fundamentally rewrite CoBanks lending charter to allow loans to corporations that may have no farmer involvement and that may be unrelated to agriculture.

ICBA's general viewpoint is that we do feel it is appropriate to explore ways to enhance the accumulation of equity capital within farmer-owned cooperatives and in rural America – but this should be done in ways that don't potentially lead to the loss of legitimate farmer control of their cooperatives or in ways that drastically depart from the bedrock principles of what makes a cooperative a cooperative.

We also feel it is important to ensure that policy actions do not spur greater consolidation in agriculture and consolidation of the businesses and cooperatives that serve agriculture just for the sake of growth for some at the expense of survival for others.

Therefore, we will make some positive recommendations to attract equity capital in rural America, discuss some questions that have been raised regarding the model law adopted by two states and discuss our concerns with the CoBank legislation.

The Importance of Farmer-owned Cooperatives

First, let me mention that the farmer-owned cooperative movement has a long and proud history. Many community banks across the nation are involved in financing farmer-owned cooperatives and we believe they are often essential building blocks of strong local economies. The experience of community banks financing farmer-owned cooperatives has been mutually beneficial because the traditional farmer-owned cooperative structure serves the dual function of being responsive to the needs of local communities and also of helping to stimulate rural economic growth. And the cooperative model has proven successful at the regional and national levels as well.

In fact, we would suggest that the cooperative model can be considered an ideal model for local economic development because the structure provides for local ownership and control (one member one vote concept) and the net proceeds are distributed to its patrons – those who use the cooperative – based on the amount of their use, or their patronage. The cooperative principles compel cooperatives to also perform an important public function – serving the needs of their members – as opposed to being driven largely by a profit motive. Cooperatives achieve this by allowing their members to pool their collective resources to achieve a critical mass that provides for economic efficiencies.

In our rural areas, this means cooperatives can be controlled by local farmers and receive financing from the local bank or banks to promote the growth and interests of the local community, as opposed to an investor owned firm that would primarily be looking out for the interests of the investors, who may not be local citizens. If community residents control the cooperative, they can ensure the cooperative serves the economic interests of the community and not the objectives of people who may live far away from the community.

Therefore, cooperatives often provide services and products for local citizens rather than focusing solely on maximizing profits. Investor owned firms, by contrast, can be under pressure to grow as fast as possible, often outgrowing the community's interests – meaning the business may decide to relocate to a more urban or suburban setting as it grows instead of remaining in the local community. An investor driven company may decide to relocate away from the rural community to have greater access to a larger labor force, ample technology resources and a greater supply of services and social amenities. This can contribute to the “out-migration” problems affecting many of our rural communities.

Locally owned, farmer-controlled cooperatives also help the rural economy by producing jobs in and around the community and adding value to products that farmers grow, generating additional cash flow both to the farmers and to the local economy.

Ethanol plants are a good example, and a new energy bill that contains a front-loaded Renewable Fuels Standard (RFS) would be very helpful and we urge Congress to pass a new energy bill soon.

We should also keep in mind that there are thousands of cooperatives operating successfully in rural America today and new ones are being started. In fact, last week the Des Moines Register carried an article about the opening of a new farmer-owned beef cooperative, Iowa Quality Beef, which attracted capital from 900 farmers in a dozen states. Additional financing was provided by a major bank and a community bank provided the real estate loan for the project. Also, the Farm Bureau contributed \$1 million investment to acquire 20,000 shares of Class C preferred stock with the promise of an 8 percent annual return once the plant becomes profitable. The plant is the first beef packing plant to open in Iowa in decades and will provide producers with an alternative market for the high-quality beef cattle raised in Iowa, known world-wide as "I-80 beef." The new cooperative will help create jobs and support the state's corn and soybean industries and the state's rural economies.

Financing the Farmer-Owned Cooperatives of Tomorrow & Today

Generally speaking, operating on a cooperative basis means that the organization exists for the benefit of its members. The return on capital is usually limited because the purpose is to either market products and then return the proceeds minus selling expenses, or to provide a service or product to patrons at the lowest possible cost. Benefits of being part of the cooperative are returned to the members on a patronage basis rather than on an investment basis. With cooperatives, democratic member control uses the one-person-one-vote system.

Obviously, any business, whether a cooperative, a single proprietorship, a corporation or other corporate structure, needs to have a certain amount of equity to begin, operate and maintain their business operations. In rural America, it has been evident that there are plenty sources of "debt" capital. Any credit-worthy business can get a loan from a commercial bank and often times there are several community banks vying for a potential customer's business within the community. It is also true that any business that opted to form an LLC according the two new state laws would have ample choices of financing available from the private sector.

But many suggest that attracting ample equity capital, as opposed to debt financing that lenders provide, is the real challenge in rural America. Certainly farmer-owned cooperatives have found this to be true at times. Beginning in 1998, the ag economy went into a tailspin as commodity prices became severely depressed, making it hard for many farmers to cash flow, let alone have income to contribute as equity capital to cooperatives.

In recognition of this, Congress has either adopted or updated several programs. Unfortunately, several of these USDA authorities either sit idle today or have yet to be fully implemented. These authorities are listed below along with our recommendations.

- ❑ ***Rural Business Investment Corporations (RBIC)*** – Section 6017 of the new Farm Bill establishes a new *Rural Business Investment Program* to provide \$44 million in grants and \$280 million in guarantees for rural business investment companies to establish a developmental venture capital program that provides equity investments for rural businesses. The program is modeled after the Small Business Investment Company (SBIC) program, used primarily in larger metro areas, but targets at minimum 75 percent of its resources to rural areas. The program would allow companies to considerably leverage their equity resources up to three times their capitalization; provides operating grants up to \$1 million and other benefits to increase rural equity capital.

As stated in the managers' amendment on the farm bill, it was the expectation that rules could be proposed in "a very short time", but we have seen no proposed regulations yet. We also note that institutions can form RBICs if they have capital of \$2.5 million or greater. However, only those institutions with \$5 million to \$10 million are eligible for a guarantee on their debentures. While these levels may be appropriate for their city cousins, the SBICs, this amount of required capitalization is higher than necessary for rural areas and this threshold should be significantly lowered to attract the formation of more RBICs.

- ❑ ***Cooperative Stock Purchase Program*** – Section 6017 of the new farm bill also includes new authorities under the Business & Industry (B&I) program to provide loan guarantees for the purchase of cooperative stock. B&I loans can be guaranteed to farmers, ranchers or cooperatives to purchase start-up capital stock for expanding or creating an agriculture co-op. The Secretary may guarantee a loan to a producer to join a co-op in order to sell products the farmer produces. Also the program was modified to allow existing cooperatives to be eligible for the program in addition to start-up cooperatives.

This program is virtually unused and we believe consideration should be given to allowing the Farm Service Agency (FSA) to manage the program either in part or in its entirety. For example, Sec. 6017 (2)(C) requires that financial information from a farmer or rancher as a condition of receiving a B&I loan guarantee be provided in a manner generally required by commercial ag lenders. Commercial ag lenders generally are heavy providers of FSA guaranteed farm loans to farmers and individual farmers are used to receiving farm loans, as opposed to larger business loans.

Therefore, we believe the program would operate more smoothly if it were transferred to FSA, or at least allow FSA to be the agency that guarantees loans to farmers and ranchers for purchase of cooperative stock. Under this scenario, established cooperatives could continue to have the option of receiving guaranteed loans for stock purchases from USDA's Rural Businesses Cooperative Services agency. We believe aggressive use of this program would be a significant boost for rural farmer-owned cooperative equity enhancement.

- ❑ ***Value Added Ag Market Development Grants*** – This program authorizes \$40 million per year from the CCC and relaxes eligibility to increase participation by allowing producer groups and “majority controlled producer based business ventures”, as determined by the Secretary, to compete for grants designed to develop value-added products or markets. One of the purposes of these grants is to “provide capital to establish alliances or business ventures that allow the producer of the value-added ag product to better compete in domestic or international markets.”
- ❑ ***Ag Innovation Centers*** – Congress has also authorized funding for a new Agriculture Innovation Center Demonstration Program to provide technical assistance, business and marketing planning, and other non-financial assistance to value-added businesses. The program should better meet producers’ interests in start-up farmer-owned value added processing facilities while establishing resource centers to assist producers in value-added endeavors. The added funding will enable producers to capture more of the value of their commodities. The law emphasizes one purpose of these grants is “increasing and improving the ability of local agricultural producers to develop markets and processes for value-added agricultural commodities or products . . .”.
- ❑ ***Additional Farm Bill Authorities for Large Farmer Cooperatives*** – The rural development title of the farm bill also contains a number of provisions sought by large cooperatives. These include provisions relating to being able to receive B&I loans in excess of \$25 million; allowing cooperatives headquartered in metropolitan areas to receive loans if the loans are used for projects in rural areas; and allows for consideration of the cooperatives’ brand, patents and trademarks in determining eligibility.
- ❑ ***Simplified Loan Applications for Small B&I Loans*** – There was also a provision in the rural development title advocated by ICBA that mandated the Secretary to provide “lenders a short, simplified application form for guarantees” on loans up to \$400,000 under the B&I program and for loans up to \$600,000 after fiscal year 2004. This would effectively be an increase in the loan amount that qualifies for the streamlined loan documentation form from the previous \$50,000 level, which was ineffective because of its small size. The FSA farm loan level under the low-doc program was also supposed to be increased to \$125,000.

Increasing the low-doc level for the B&I loans should be a simple process but no regulations have come forward. Reducing the paperwork involved for lenders and their customers in securing rural small business loan guarantees is a complimentary step to attracting and/or maintaining adequate equity capital investments in their rural businesses. We ask the committee to urge USDA to immediately issue regulations on this provision in the farm bill.

A Model Adopted in Two States

A Question has also been raised as to whether we need to make the farmer-owned cooperative model more “flexible” in order to enhance the ability to raise equity capital and address other issues, such as ensuring ample product availability, greater market share and greater economies of scale. Some may suggest that cooperatives cannot survive in today’s agricultural economy, characterized by intense international competition and costly new technologies, unless they can form strategic alliances, joint ventures and other relationships between companies, whether cooperatives or non-cooperatives, in an effort to attract greater capital and access more markets.

In discussing the structure of farmer-owned cooperatives, one cooperative source we reviewed noted that there have indeed been some recent failures among agricultural cooperatives, citing for example Farmland Industries and the sale of assets of the Minnesota Corn Processors to ADM. But then the source added this thoughtful comment:

“While recent events may seem troublesome, they provide no evidence that the cooperative model is failing. To the contrary, there are many very successful cooperatives in business today. Cooperatives, like any other business structure, experience problems, failures or structural evolutions. Any number of major public stock companies have closed their doors or been purchased by other entities, yet there is little talk that the public stock company has failed.”¹

It is important to realize that there are many methods that can be used help farmer-owned cooperatives to attract equity capital. Obviously an important source is and should remain the capital generated by the patronage of the cooperatives’ members. Cooperatives can also form joint ventures or strategic alliances with other cooperatives and with outside investors to share their resources for a particular project. My point is that several options are available that allow cooperatives to “cooperate” between different types of businesses, whether they share the same or a different corporate structure, without one business, the farmer-owned cooperative, being taken over by outside investors.

When Do Cooperatives Cease Being Cooperatives?

In viewing the laws that have been adopted by two states it is important to keep in mind basic principles of farmer-owned cooperatives: 1) Owned by farmers; 2) Controlled by farmers; 3) Each member has one vote – “one member, one vote” – a bedrock principal of cooperatives; and 4) Earnings allocated to farmers based on patronage, rather than to investors based on investment.

The two state laws allow: membership made up of both patrons and outside investors; a minimum of three directors; at least one member elected by patron members; and the patron member has at least 50% of the voting power.

Several questions have been asked regarding governance: 1) Should boards of these LLC entities be required to have more than one patron board member?; and 2) Should patron members have more than 50% control of their cooperatives if they are going to adhere to cooperative principles and be eligible for benefits as cooperatives?

The laws adopted at the state level in Wyoming and Minnesota allow for allocations and distributions on the basis of patronage for patron members and investment for investor members. For example, allowing for 15 percent of allocations and distributions going to patron members regardless of ownership level. This would leave 85 percent available for investors based on their investments. Questions include: 1) Does the 15% level adequately protect the patron members?; 2) If investors can withdraw 85% of the profits from the cooperative, does this adequately ensure more equity capital is available for the cooperative?

A USDA analyst raised several questions relating to the Wyoming state law: Basically, these concerns involved the following issues:

- ❑ Such entities may be incompatible with the traits that distinguish a cooperative from an investor-owned firm.
- ❑ Serious questions exist as to whether such an entity is eligible for the public policy benefits available only to cooperatives.
- ❑ Under this law, a cooperative can have an unlimited number of investor non-patron members who aren't required to do business with the association, but are entitled to vote and share in its earnings on the basis of their level of investment.
- ❑ Patron members are limited to one vote each, while non-patron members may have an unlimited number of votes.
- ❑ Only one of an unlimited number of directors must be elected by producer patron members.
- ❑ Director(s) chosen by the producer-patron members are entitled to 50 percent of the voting power on the board. But this may fall short of the level of producer control that is necessary to operate as a farmer cooperative.
- ❑ No limit is imposed on the rate of return investor-members can realize on their investment, and up to 85 percent of each year's earnings may be distributed to investor members based on investment.
- ❑ One or more outside investors with two-thirds voting control can merge or consolidate the entity into another entity, or liquidate it without any support from the producer patron-members. (emphasis added)

The analysis added this comment:

“Delaware could amend its laws to create another statute that lets General Motors or any other large investor owned firm call itself a ‘cooperative.’ But if such entities disregard the key cooperative characteristics of user ownership and control and benefits flowing to the users based on patronage the integrity of all cooperatives is called into question.

The analysis then suggested that an entity structured under this law may have trouble qualifying for benefits that adhere to several federal statutes including anti-trust immunity; Subchapter T taxation treatment; exemptions from filing of securities under the Securities Act of 1933; and the Ag Marketing Act of 1929.

These issues may be worthwhile for federal policymakers to ponder and for the agriculture industry to consider at length.

CoBank Legislative Proposal

The issues mentioned above also relate to CoBank's legislative proposal as well. We do not see a dire need to immediately pass legislation before Congress adjourns this year that would dramatically alter CoBank's lending charter.

Rather, we believe there should be a broad discussion of these issues within the agriculture industry. This "discussion" should imply much more than simply circulating letters asking organizations to support broad concepts under the notion that some lenders cannot get involved in certain loans to legitimate farmer owned cooperatives.

It should be well understood that financing for these cooperative ventures, even if restructured as LLCs, is available from the Farm Credit System (FCS) direct lender associations as well as commercial banks. The CoBank legislation does appear to risk allowing CoBank, as a national discount GSE lender, to undercut local lenders, whether FCS associations or commercial banks. CoBank can currently participate in financing legitimate agricultural enterprises through loan participations with other lenders, which helps ensure local lenders are not driven from the local marketplace. Some additional concerns include:

Who is a farmer? We believe the current Farm Credit Administration (FCA) definition of who is a "bona fide" farmer is quite suspect. Current law requires the FCS to make loans to "bona fide" farmers and those farm related businesses that support them under certain conditions. However, the FCA defines a "bona fide" farmer as anyone who owns land that could one day be used for production. Anyone (individual, entity, corporation, etc.) who owns an acre of pasture land could therefore be considered a "bona fide" farmer by FCA regardless of whether the individual or corporation ever produces an agricultural commodity or has agricultural sales.

This issue has come into play recently because the FCA has asked for public comment on a proposal by the FCS to be able to make **non-farm** loans to anyone their local boards of directors determines is eligible. These loans, again, would be for **non-farm** purposes in any amount without any criteria that the loans serve an agricultural purpose or are related to an individual's farm production. We believe this is totally inappropriate and directly contradicts the statute's wording and the legislative history as well as the mission and charter of the FCS, which was created with specific advantages as a government sponsored enterprise (GSE) to serve farmers and ranchers.

Under FCA regulations, it appears that Ted Turner, Wal-Mart and a number of large corporations that own some land in rural America could be considered “bona fide” farmers. Since LLC’s can be formed with only one or two members and since the two state laws allow the LLC boards to be comprised of only three individuals with one being the “patron” member, the “farmer-owned cooperatives” that CoBank could finance could include two large corporations and a couple of individuals (or companies) considered “farmers” because the “farmers” own a couple acres of land.

The issue is also important in the context of the CoBank proposal because they request authority to make loans to entities with *both* a producer and investor class of membership so long as the producer class holds at least 50% of the voting control **OR** ownership interest. This eliminates the current statutory requirement that producers must hold at least 80% of the voting control of their cooperatives.

It also would allow CoBank to finance entities defined as “cooperatives” pursuant to **State** laws, not Federal laws. In addition, they propose to finance any current customer for up to 5 years that by law would not be eligible to receive such financing because the customer is no longer a farmer-owned cooperative, i.e., does not meet the 50 percent farmer ownership **OR** farmer voting control criteria.

Therefore, one basic question that could be asked is whether the “producer” class is comprised of real farmers. In addition to weak or non-existent definitions of “farmer”, these “new cooperative business structures” would have no restrictions on who the investors are and no requirements the business entity is majority owned or controlled by farmers – in other words by patron members who produce commodities for delivery to the Cooperative.

As written, this proposal will allow CoBank to finance these new types of businesses even if farmers hold significantly less than 50% of the ownership control. For example, outside investors could control 60%, 70%, 80%, 90% or more of the business, allowing them to dictate how the “cooperative” serves its members and markets.

Draft Language is Not Narrowly Drawn – The suggestion may be made that the draft legislative language is narrowly drawn to allow CoBank to finance newly converted or new farmer-owned agricultural cooperatives that form as LLCs. But the draft language does not define an “association of farmers”. It also allows the “farmer-owned cooperative” to remain eligible even if the business ownership or voting control requirements are substantially weakened if the “association” continues to be designated as a “cooperative” under state law.

Once designated a “cooperative” how likely is it the State will actively monitor or FCA will review all the business structures to determine if they are still acting as “cooperatives”? How likely is it the State or FCA will review the business operations to determine if the LLC still contains 50% farmer ownership or 50% farmer voting control?

This weakening of the minimal 50% option for farmer ownership or farmer voting control is further watered down by allowing any *ineligible* entity to remain eligible for CoBank financing for 5 years after the beginning of the ineligibility. There is no need for such a provision since **businesses secure financing before major changes occur, not after.**

Who really believes that CoBank won't subsequently lobby to continue to be able to finance these ineligible entities at some point within the next five years to be able to "continue what they've been doing to meet the financial needs of . . ."?

Allows CoBank to Finance Corporations Outside of Agriculture – The draft language then allows for instances where the "farmer-owned cooperative" may be bought out by a large corporation since the title of "association" is then transferred to "any legal successor", which implies any non-farmer-owned, non-farmer controlled corporation. Thus, CoBank could be financing large corporations under this authority that are not "associations of farmers", not operated on a cooperative basis and that have no farmer ownership or farmer voting control.

The legal successor may be a large private corporation, foreign or domestic, where the agricultural interests are only a minor portion of the corporation's overall business activities, but the draft language suggests CoBank could finance **both** the large parent corporation **AND** any subsidiary or related entity that receives transferred assets.

These transferred assets would only need to comprise 50% of the assets of the subsidiary, based on **book value immediately after the transfer**. Such book value may have little bearing to the market value of the assets, which may be virtually worthless. This allows CoBank to finance the entity at a much higher level than the real value of the assets would suggest appropriate. The provision provides for no future accounting of the assets, as the book value is determined only at the time of transfer, not on an ongoing annual basis and not reflective of the market value of the subsidiary's activities.

Again, the language suggests the non-farmer-owned parent corporation could be financed ("**any legal successor . . . AS WELL AS any entity . . .**") even though it may not be a farmer-owned cooperative in any way and even though its business **may be completely unrelated to agriculture.**

These allowances could cause tax-paying businesses to restructure as "new cooperative business structures" to take advantage of a lower tax burden, and cheap, subsidized financing from CoBank or form subsidiaries to take advantage of these benefits.

The combination of these changes would therefore allow CoBank to completely alter the mission of their FCS government sponsored enterprise charter, moving from financing farmer-owned cooperatives with 80% farmer ownership to financing corporations that have no farmer involvement (legal successors).

Conclusion

Mr. Chairman, thank you for the opportunity to express our views today. There can be advantages in seeking outside capital for cooperatives. We must weigh these advantages with the potential for conflict with the interests of the farmers who own these cooperatives. **Control follows money.**

For example, would large corporations be called “cooperatives” under some state laws when they really aren’t, and be eligible for benefits as cooperatives, and receive financing from CoBank, and potentially compete against farmer-owned cooperatives? Will traditional farmer-owned cooperatives seeking financing from CoBank be told in the future that they need to secure significant outside investor equity (and control) to receive financing?

A USDA spokesman recently testified that a traditional benefit to farmers through farm cooperatives has been “the return of earnings to local producers on the basis of their use of their cooperative, rather than to outside investors based on their investment”. These benefits include, “A diverse local ownership unlikely to sell out or close down unless forced to do so, thereby protecting the local economy from the loss of a valuable asset.”

With various federal statutes on the books, Congress should help ensure that farmers’ interests are protected at the federal level in any developing trends that may set the stage for how some cooperatives could be formed in the future. Caution should be in order to ensure that large U.S. corporations do not have a tool to unfairly leverage their interests against family farmers.

These issues should be thoroughly discussed – *before* there is a rush to pass the CoBank legislative proposal that would fundamentally rewrite CoBank’s charter allowing them to lend to non-cooperatives and non-agriculturally oriented corporations. CoBank’s very broad legislative proposal needs much further analysis given its vast scope and its potential to shape how future cooperatives and corporations may structure themselves and given that there is no pressing need to adopt the proposal this year. We also encourage Congress to urge USDA to implement the existing authorities contained in the farm bill to help attract equity capital to rural America. We look forward to working with you on these endeavors and further exploring the important issue of attracting greater equity capital to rural America’s farmer-owned cooperatives. Thank you.

1 *Working Together*, directors message, “Lessons in Corporate (or is that cooperative?) Responsibility”, UWCC, University of Wisconsin, pg 1